

## Summary of PRC Order 5763: Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products

### 1. Overview

The Postal Accountability and Enhancement Act (PAEA), which established the current system for regulating rates and service for market dominant products, included a provision that the Postal Regulatory Commission (PRC) must review the system after ten years to determine whether the factors and objectives of PAEA were being met. In accordance with that provision, the PRC initiates a rulemaking proceeding (RM2017-3) in December 2016. After multiple proposals and extensive comment, the PRC has determined that:

- The system was largely successful in achieving the goals related to the structure of the ratemaking system. However, the Commission concluded that the ratemaking system had not increased pricing efficiency.
- The system had not maintained the financial health of the Postal Service as intended by the PAEA. While the Postal Service had generally achieved short-term financial stability, both medium-term and long-term financial stability measures had not been achieved.
- High-quality service standards had not been maintained during the 10 years following the enactment of the PAEA.

To address perceived shortcomings in the current system, the PRC has [issued](#) Order 5763 which modifies the current system. A substantial portion of Order 5763 addresses legal issues or summarizes comments from various parties during the RM2017-3 proceeding. This summary will not include those sections.

The PRC Order in RM2017-3 (10 year review), grants the Postal Service additional rate authority above the current CPI price cap, introduces a floor for workshare passthroughs and imposes additional reporting requirements on USPS. The new regulations will take effect in early 2021 and will be subject to review five years thereafter. The Order will modify regulations impacting rate levels, workshare passthroughs, and reporting by the Postal Service, each of which is addressed below.

The Order is final and will take effect 30 days after publication in the Federal Register, but subject to possible review by the DC Circuit Court. The Commission will be conducting a separate rulemaking proceeding to consider possible changes in regulation to reflect changes in productivity and/or service standards. The system established by this Order will be reviewed by the PRC five years after implementation.

## 2. Additional Pricing Authority

### a. Density based pricing authority

Consistent with its 2019 [Order](#), the new regulations allow additional pricing authority to the Postal Service to offset “exogenous increases in per-unit cost due to declines in the average volume of mail per delivery point”. (Order page 34). Using inputs that the Postal Service will be required to provide as part of its Annual Compliance Report (ACR), the supplemental pricing authority is based on:

- The institutional cost ratio defined as Institutional Costs/Total Costs
- Changes in the number of delivery points
- Year over year volume changes.

The formulas used to calculate the density based pricing authority are presented in an appendix below. Had the density adder been in place during the previous eight years, the resulting supplemental pricing authority is presented in the table below. The PRC Order allows the Postal Service to “bank” unused density pricing authority for use in future years.

### Hypothetical Density Rate Authority Calculations

<b>FY Density Rate Authority Authorized</b>	<b>Based on Data from FYs</b>	<b>Institutional Cost Ratio</b>	<b>%Δ Density (MD)</b>	<b>%Δ Density (Total)</b>	<b>Density Rate Authority</b>
2013	2011 & 2012	50.06%	-6.06%	-5.38%	2.69%
2014	2012 & 2013	45.84%	-1.89%	-1.51%	0.69%
2015	2013 & 2014	46.60%	-2.94%	-2.68%	1.25%
2016	2014 & 2015	45.69%	-1.92%	-1.57%	0.72%
2017	2015 & 2016	47.15%	-1.11%	-0.76%	0.36%
2018	2016 & 2017	42.62%	-4.53%	-4.04%	1.72%
2019	2017 & 2018	41.13%	-3.41%	-2.95%	1.21%

b. Retirement Pricing Authority

Concerned that amortization payments to fund USPS retirement obligations are beyond USPS control, the PRC modifies the price cap to provide additional Market Dominant rate adjustment authority equal to the percentage by which total revenue would need to increase (necessarily assuming an equal increase levied on Competitive products) to provide sufficient revenue for the Postal Service to meet its required retirement obligation payments, as calculated under the Commission’s formula (see appendix). Availability of the retirement rate authority is predicated on the Postal Service using any revenues derived from this authority to make required amortization payments to reduce its retirement liabilities.

To protect Market Dominant mailers from a large initial rate shock, this additional rate authority will be phased in over 5 years, with annual recalculations to ensure ongoing accuracy during the phase-in period. The PRC has estimated hypothetical retirement rate authority over the next five years as shown below. The formula for determining retirement rate authority is included in the appendix to this summary.

<b>FY</b>	<b>Compounded Retirement Rate Authority Through Previous FY</b>	<b>Additional Retirement Rate Authority</b>	<b>Date Retirement Rate Authority Authorized</b>	<b>Date of Rate Increase</b>
2021	0.000%	0.861%	January 31, 2021	September 2, 2021
2022	0.853%	0.827%	January 31, 2022	September 15, 2022
2023	1.666%	0.918%	January 31, 2023	September 5, 2023
2024	2.560%	1.111%	January 31, 2024	September 3, 2024
2025	3.631%	0.970%	January 31, 2025	September 6, 2025

c. Non-compensatory products and classes

Products or classes are considered to be non-compensatory or “underwater” when attributable costs exceed revenues as determined in the most recent Annual Compliance Determination (ACD). Products may be non-compensatory but still exist within classes where the overall revenue for the class exceeds attributable costs. The PRC has proposed different approaches.

i. Non-compensatory classes

To enable the Postal Service to improve the cost coverage of non-compensatory classes e.g. Periodicals, the PRC is authorizing an additional 2 percent pricing authority above CPI. To allow USPS to consider ECSI, and other factors that might influence pricing decisions, the PRC will allow USPS to bank unused authority of this type and to allow discretion to the Postal Service regarding how much of its additional authority to use in such cases.

ii. Non-compensatory products within classes

For non-compensatory products within classes for which total revenues exceed attributable costs, the PRC will require that the Postal Service, in the event USPS changes prices, the price increases for non-compensatory products within said class must exceed the class average increase by 2 percent. This additional authority does not create additional rate authority for the class as a whole.

### **3. Workshare Changes**

The PAEA included a provision that workshare discounts could not exceed 100 percent of the costs avoided by the work undertaken by the mailer unless certain specific exceptions obtained. The PAEA had no corresponding floor and as a result many workshare passthroughs remain well below 100 percent. Having determined that the pricing efficiency objective of PAEA is not being met, the Order establishes workshare bands governing workshare passthroughs.

To address this inefficiency, the PRC is setting a floor on workshare discounts of 85% of avoided costs and treating any workshare discount that exceeds 100% of avoided costs as excessive. These rules are intended to move USPS pricing closer to efficient component pricing (ECP). The new regulations provide the opportunity to request a waiver for a passthrough that falls outside of the new bounds. As noted in the Order “(a)

A low workshare discount or an excessive workshare discount would be permitted if it was new, if it would represent an improvement of 20 percent over the existing workshare discount passthrough, or if it was set in accordance with a prior Commission order (via the proposed waiver process).”

#### **4. Additional Reporting Requirements**

The PRC acknowledges in its order that the CPI price cap is one of the primary incentives for efficiency. Because Order 5763 provides the Postal Service considerable pricing authority in addition to CPI, the Commission has determined that it would be prudent to implement reporting requirements that could “serve as a counterbalance by requiring the Postal Service to focus its efforts on identifying the underlying causes of cost increases and developing concrete plans to reduce costs.”

In addition to specifying information reported in the ACR that will be used to calculate supplemental pricing authority, the PRC is expanding what USPS is required to report in the ACR to include

- A consolidated cost analysis report detailing costs for individual Market Dominant products, Market Dominant products collectively, and for the entire postal system.
- Reporting with regard to cost-reduction initiatives expected to cost the Postal Service at least \$5 million over the duration of the initiative. For each such initiative, the Postal Service would be required to file a narrative including an overview of the initiative, its status, the expected Postal Service expenditure on the initiative, the start date, the end date, and any intermediate deadlines. The Postal Service would also be required to identify a metric to be used to measure the expected impact of each cost-reduction initiative in future years, as well as a timeline detailing when the Postal Service expected to see the impact.
- Provision of summary information pertaining to approved decision analysis reports (DAR). A DAR is an internal Postal Service document required for each capital spending project that has total costs over \$1 million. USPS will be required to provide the following information for all projects associated with a DAR in the current and next fiscal year: a description of the project; the status of the project; an estimate of cost savings or additional revenues from the project; and the expected return on investment from the project.

## 5. Other Issues

An earlier PRC proposal included additional pricing authority based on performance that would have provided USPS with an additional 1 percent pricing authority based in improvements in productivity – as measured by changes in total factor productivity (TFP) – provided that the Postal Service maintained service standards. Order 5763 does not include this feature; the PRC has indicated they will consider the possible addition of performance-based pricing authority in a separate rulemaking proceeding.

Under the new regulations, the Postal Service must now provide 90 days notice prior to changing any market dominant rates. The existing required notice period is 45 days. The PRC will conduct a review of its regulations after they have been in place for five years.

## Formulas Used to Determine Supplemental Rate Authority

### Density Rate Authority

The formula for calculating the amount of density rate authority is as follows:

Density rate authority = the greater of 0 and

$$-1 * \frac{IC_T}{TC_T} * \% \Delta D_{[T-1,T]}$$

Where,

T = most recently completed fiscal year

T-1 = fiscal year prior to fiscal year T

IC<sub>T</sub> = institutional cost in fiscal year T

TC<sub>T</sub> = total cost in fiscal year T

%ΔD<sub>[T-1,T]</sub> = Percentage change in density from fiscal year T-1 to fiscal year T

(2) The formula for calculating the percentage change in density, in conformance with paragraph (b)(2) of this section, is as follows:

Percentage change in density from prior fiscal year =

$$\frac{\frac{V_T}{DP_T}}{\frac{V_{T-1}}{DP_{T-1}}} - 1$$

Where,

T = most recently completed fiscal year

T-1 = fiscal year prior to fiscal year T

V<sub>T</sub> = volume in fiscal year T (either market dominant volume or total volume as discussed in paragraph (b)(2) of this section)

DP<sub>T</sub> = delivery points in fiscal year T

The amount of density rate authority available under this section shall be calculated in three steps. First, the percentage change in density during the most recently completed fiscal year shall be calculated. Second, this percentage change shall be multiplied by the institutional cost ratio, which is calculated as institutional costs for the most recently completed fiscal year divided by total costs for that fiscal year. Finally, this product shall be multiplied by negative 1 so that declines in density correspond to a positive increase in rates. If the result of this calculation is less than 0, the amount of additional rate authority shall be 0.

The percentage change in density from the prior fiscal year shall be calculated as the ratio of volume to delivery points for the most recently completed fiscal year, divided by the same ratio for the prior fiscal year, and subtracting 1 from the quotient. The result is expressed as a percentage, rounded to three decimal places. To ensure that decreases in competitive product volume will not result in the Postal Service receiving greater additional rate adjustment authority under this subpart, the percentage change in density shall be calculated two ways: using market dominant volume and using total volume. The greater of the two results (not using absolute value) shall be used as the percentage change in density from the prior fiscal year.

### **Retirement Rate Authority Formula**

Retirement rate authority available in fiscal year T+1 =

$$\left(1 + \frac{AP_T}{TR_T} - PARA_T\right)^{\frac{1}{5-N}} - 1$$

Where,

T = most recently completed fiscal year;

AP<sub>T</sub> = total amortization payment for fiscal year T;

TR<sub>T</sub> = total revenue in fiscal year T;

PARA<sub>T</sub> = previously authorized retirement obligation rate authority, compounded through fiscal year T, expressed as a proportion of the Market Dominant rate base and calculated using the formula below; and

N = number of previously issued determinations in which retirement obligation rate authority was made available under this subpart.

## Summary of USPS Pricing Authority for Market Dominant Prices According to Order 5763

### Sources of USPS Pricing Authority

Pricing Authority	Source	Updated	Typical Range (annual)	Bankable
CPI	Bureau of Labor Statistics	Monthly	1-3%	
Density	USPS, ACR	Annually	0-5%	
Retirement	OPM, USPS	Annually	0-1.25%	
2% non-comp class	USPS, ACR	Annually	NR	
2% non-comp product	USPS, ACR	Annually	NR	